United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-1166

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

PHILIP HANDELMAN and ESTHER HANDELMAN,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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Certain of taxpayer's arguments require a response, and this reply brief is directed toward that end.

I

THERE WAS NO SALE OR EXCHANGE OF TAXPAYER'S GRAPHIC ARTS STOCK

As we noted in our opening brief, the Internal Revenue Code affords capital gain treatment only where there has occurred a "sale or exchange" of a capital asset. Accordingly, it is well settled that payments received in respect of an unconsummated agreement are taxable as ordinary income, because no sale or exchange has taken place in such a situation, and the seller not only receives the payments in question but retains the capital asset as well. Binns v. United States, 385 F. 2d 159 (C.A. 6, 1967), aff'g 254 F. Supp. 889, 891 (M.D. Tenn., 1966);

Myers v. Commissioner, 287 F. 2d 400 (C.A. 6, 1961), cert. denied, 368 U.S. 828 (1961); Mittleman v. Commissioner, 56 T.C. 171, 178-179 (1971), aff'd, 464 F. 2d 1393 (C.A. 3, 1972); Johnson v. Commissioner, 32 B.T.A. 156, 161 (1935). Taxpayer simply never deals with our point that there is no sale or exchange present in this case.

1. None of the several arrangements, pursuant to which Van de Maele and O'Connor unsuccessfully attempted to purchase varying quantities of taxpayer's Graphic Arts stock for different amounts of consideration, was ever consummated. (R. 63-64, 78-82, 156, 159-161; Ex. Vol. 14-15, 17, 39-41, 75-79.) Nor was any of taxpayer's stock ever delivered to Van de Maele and O'Connor prior to 1970, when the litigation in the New York state court over the promissory notes and Van de Maele and O'Connor's $105,500 counterclaim (Ex. Vol. 16-17, 18-21, 36) was settled. Taxpayer never surrendered and Van de Maele and O'Connor never acquired any of the rights and obligations attaching to any of the stock in the interim. (R. 63-64, 82, 157-160, 162; Ex. Vol. 20-21, 23, 24, 28-29, 69, 78, 79.) Quite simply, there occurred no sale or exchange for the purposes of the capital gain provisions of the Code.[1/]

1/ Taxpayer does not appear to dispute that whether a sale or exchange occurred involves "the legal characterization, for federal income tax purposes, of the transactions between the parties," and, accordingly, is "not a question of fact, but rather one of law," which is fully reviewable by this Court on appeal. Union Planters Nat. Bank of Memphis v. United States, 426 F. 2d 115, 117 (C.A. 6, 1970).

2. Taxpayer's unsupported allegation (Br. 3), that Van de Maele and O'Connor agreed to purchase "taxpayer's stock interest for $221,000," is erroneous. Certainly the Tax Court made no such finding in this case (R. 155-156), and the record hardly supports such an assertion. On the other hand, it is evident that the $95,000 in issue was received, according to taxpayer's own testimony, to secure his agreement to escrow the various number of shares to which each of the attempted transactions related. (R. 63-64, 66-67, 68, 73-74.) As these several arrangements terminated, taxpayer simply retained the $95,000.

3. Rule 1 of Section 100 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann., relied on by taxpayer (Br. 12-13, 22-23), is wholly irrelevant to the treatment of the $95,000 for federal income tax purposes. As we noted in our opening brief (pp. 18-19), that section deals only with rules "for ascertaining the intention" as to when "the property in the goods is to pass to the buyer" under a sales transaction. It does not, in itself, effect a sale or exchange, and the section is immaterial to a determination of whether such a transaction occurred. See Section 82, Personal Property Law, McKinney's Consol. Laws of N.Y. Ann. ("Contracts to sell and sales"), which states that a "sale," by definition, requires a seller to "transfer" property in goods to the buyer. In

addition, taxpayer fails to deal with our point (pp. 18-19) that stock transfers must also meet the specific terms of Section 162 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann.[2/]

4. Moreover, there is no substance to taxpayer's assertion (Br. 12-13) that the several shifting arrangements between himself and Van de Maele and O'Connor caused some sort of instantaneous passing of title in some undisclosed and indeterminate number of his Graphic Arts shares; taxpayer never addresses the determinative fact that all the benefits and responsibilities relating to the stock remained at all pertinent times with him, and that these attributes are controlling for purposes of the sale-or-exchange requirement of the Code. Cf. Titcher v. Commissioner, 57 T.C. 315, 323 (1971); Mechanic v. Commissioner, 19 T.C.M. 667, 668 (1960).

5. Indeed, rather than addressing the determinative "sale or exchange" requirement, taxpayer incorrectly asserts (Br. 16-22) that the Commissioner's argument herein depends on whether there was a technical forfeiture, under state law, or a specific liquidated damages provision relating to the $95,000 in issue. Such is not the case. The common thread between

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2/ While Sections 100 and 162 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann., were not mutually exclusive, it is clear that the specific provisions of Section 162, which was part of the New York analogue of the Uniform Stock Transfer Act, was controlling for purposes of a valid transfer of stock. See, e.g., Coyne v. Chatham Phenix Nat. Bank & Trust Co., 155 Misc. 656, 660, 281 N.Y.S. 271, 276-277 (City Ct. of N.Y., 1935), a case which also emphasizes the necessity of delivery of a stock certificate under Section 162 before title can pass.

this case and the other cases we rely on is that no sale or exchange was ever consummated here, yet taxpayer, nevertheless, received and retained the $95,000. Whether there was a technical forfeiture or not is beside the point; the $95,000 is taxable as ordinary income because capital gain treatment is only available where there has occurred an actual and consummated "sale or exchange." Helvering v. Flaccus Leather Co., 313 U.S. 247 (1941); Smith v. Commissioner, 50 T.C. 273, 279-280 (1968), aff'd per curiam, 418 F. 2d 573 (C.A. 9, 1969). (See our opening brief, pp. 14-18.)

6. Certainly, taxpayer's action in the New York state court did not accomplish the necessary "sale or exchange" of his Graphic Arts stock. As we have noted (Br. 7-8, 19 (fn. 6); infra, fn. 3), taxpayer's action was based on the promissory notes and not on any purported contract of sale (Ex. Vol. 8-11, 35-36, 49-53).[3/] Similarly, the settlement of April, 1970, does not serve to retroactively create a sale or exchange where none occurred. See Dobson v. Commissioner, 321 U.S. 231, 232 (1944). It merely compromised the litigation, including the

3/ Thus, taxpayer's reliance (Br. 7-8) on the decision in his New York state court case is shortsighted, since the question here is whether any of the several arrangements between taxpayer and Van de Maele and O'Connor ever constituted a sale or exchange for federal income tax purposes. Indeed, the reference in the state court decision that the defense of an oral defeasance provision was "commercially incredible" (Ex. Vol. 35) obviously relates simply to the legitimacy of such parol evidence to defeat liability on the notes which were unconditional on their face. Significantly, the court denied taxpayer relief where his claim was "not proved by document." (Ex. Vol. 36.)

issues deferred for later resolution by the state court relating to the $105,500 counterclaim against taxpayer, at a time when Graphic Arts had already been dissolved and the corporation's proposed plans were defunct. (R. 69, 75; Ex. Vol. 16-17, 18, 20-21, 28-29.)

II

TAXPAYER IS NOT ENTITLED TO REPORT THE $95,000 ON THE INSTALLMENT METHOD

As we have noted (Br. 21-22), taxpayer is not entitled to the benefits of installment reporting because there was no "sale or other disposition" of his Graphic Arts stock, as is required by Section 453(b)(1)(B), Internal Revenue Code of 1954 (26 U.S.C.).[4/] Billy Rose's Diamond Horseshoe, Inc. v. United States, 448 F. 2d 549 (C.A. 2, 1971). In addition, the several arrangements between taxpayer and Van de Maele and O'Connor pertained to different quantities of stock (first 83 shares, then 88 shares, then 104 shares, and finally 64 shares) (Ex. Vol. 20-21, 23, 24, 43, 69, 78, 79) and successively

4/ Contrary to taxpayer's assertions (Br. 1, 24), the Commissioner properly raised this issue in his deficiency notice when he disallowed taxpayer's use of the installment method for the year 1963 (R. 16), the only year in which taxpayer reported any part of the $95,000 on this basis (Ex. C; R. 111). The Commissioner also determined that the entire $95,000 was taxable as ordinary income without benefit of Section 453. (R. 15-16.) In addition, the point was raised by the Commissioner at trial (R. 52), as well as in his brief in the court below (p. 35); and, the audit statement (R. 177, 179) and the Tax Court's decision (R. 180-181) both reveal that taxpayer was erroneously allowed to report the $95,000 on the installment method. Indeed, it is somewhat remarkable for taxpayer to assert (Br. 24) that this issue is raised for the first time on appeal when taxpayer fully briefed and argued the point in the court below. (Pet. Post-Hearing Reply Memo. 16-26.)

greater amounts of consideration. It is, therefore, impossible to determine the various factors which are necessary for application of the installment method formula under Section 453(a)(1) of the Code. Gralapp v. United States, 458 F. 2d 1158, 1160 (C.A. 10, 1972). Taxpayer's allegation (Br. 3, 25) that there was a 1961 agreement to purchase his stock for $221,000 is erroneous, and the Tax Court made no such finding. Indeed, taxpayer admits (Br. 25) that there were significant alterations in the proposed price for the shares as late as 1963. In addition, taxpayer has misconceived our position on this issue, which relates only to the $95,000, and not to the three promissory notes. (The tax character and treatment of the notes are not involved in this case.)

III

TAXPAYER FAILED TO MEET THE REQUIREMENTS OF SECTION 274 RELATING TO THE DEDUCTION OF EXPENSES FOR ENTERTAINMENT FACILITIES

In our opening brief (pp. 22-34), we demonstrated that taxpayer failed to establish that his yacht was "used primarily" for business purposes, and that his boat expenses were "directly related to the active conduct" of his business, as required by Section 274(a)(1)(B), Internal Revenue Code of 1954 (26 U.S.C.). Taxpayer does not deal with these arguments, nor does he address the substantiation requirements of Section 274.[5/]

5/ Taxpayer refers (Br. 35, 50) to the so-called "clearly erroneous" rule. That standard is inapplicable here since, as we demonstrated in our opening brief, the Tax Court erred as a

1. Section 274(a)(1)(B) of the Code and Treasury Regulations on Income Tax (1954 Code), Sections 1.274-2(e)(4)(iii) and 1.274-5(c)(6)(iii) (26 C.F.R.), require a taxpayer to show that an entertainment facility was used primarily for business by substantiating, on an occasion-by-occasion basis, that "more than 50 percent" of the total days of use were related to business. None of taxpayer's evidence satisfied this requirement. Taxpayer's reliance (Br. 39) on the summaries (Ex. Vol. 95-99) is misplaced. These summaries do not establish taxpayer's total use of the yacht from which the necessary proportion of business use can be determined. Indeed, it was admitted that the summaries did not include every use of the yacht (R. 95), and the Tax Court also acknowledged that taxpayer did not account for all occasions on which the boat was used (R. 92, 99, 122-124, 128, 150, 174). Aside from the summaries, taxpayer's testimony is uncorroborated by any other evidence, a circumstance which is fatal to the deductions here under Section 274(a)(1)(B) and (d) of the Code. Similarly,

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5/ (continued)--
matter of law: (1) in failing to require taxpayer to show the business use of his yacht in relation to total use for purposes of satisfying the primary use requirement; (2) in not applying the requirement that the expenses be directly related to the active conduct of taxpayer's business; and (3) in resurrecting the Cohan rule in contravention to the legislative intent and clear provisions of Section 274(d).

taxpayer's attempt (Br. 41-42) to artificially limit inquiry into his total use of the yacht to weekend days is tantamount to a bootstrap-assisted leap over the clear and precise requirements of Section 274 and the Regulations relating to the substantiation of the primary use of a facility.

2. Moreover, taxpayer's brief does not address the total absence of evidence in the record concerning either the business relationship of the persons entertained on the yacht or the business purpose for the entertainment, which are essential elements for establishing the primary use of the facility. Treasury Regulations on Income Tax (1954 Code), §1.274-5 (b)(1) and (c)(6)(iii) (26 C.F.R.); Fiorentino v. Commissioner, 29 T.C.M. 1445 (1970), supplemental opinion, 29 T.C.M. 1665 (1970), aff'd, 455 F. 2d 1406 (C.A. 2, 1971); Ashby v. Commissioner, 50 T.C. 409 (1968).

3. With respect to the requirement of the statute that each "item" of expense relating to an entertainment facility be "directly related to the active conduct" of business, taxpayer acknowledges (Br. 43-44) that the sole use of his yacht involved the generation of goodwill among persons he hoped would become his clients. See Sec. 274(a)(1)(B), Internal Revenue Code of 1954 (26 U.S.C.). Accordingly, taxpayer's attempt to factually distinguish Hippodrome Oldsmobile, Inc. v. United States, 474 F. 2d 959 (C.A. 6, 1973), is defective, since it was held there (p. 960) "as a matter of law" that entertainment expenses

(involving facilities) for goodwill purposes are "not 'directly related to . . . the active conduct of the taxpayer's . . . business.'" (Original emphasis.) To the same effect is D.A. Foster Trenching Co. v. United States, 473 F. 2d 1398 (Ct. Cl., 1973).

4. Taxpayer also mistakenly relies on the Senate Report concerning the Senate Finance Committee's proposed draft of Section 274. (Br. 43-46.) See S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 25-26 (1962-3 Cum. Bull. 707, 731-732). As we have pointed out (Br. 29-30), and as Hippodrome Oldsmobile clearly notes, the Senate draft was rejected by the Conference Committee insofar as the Senate version would have permitted the deduction of goodwill expenses relating to entertainment facilities, such as taxpayer's yacht in this case. The House Conference Report (H. Conf. Rep. No. 2508, 87th Cong., 2d Sess., pp. 15-16 (1962-3 Cum. Bull. 1129, 1143-1144)), which we have set forth in pertinent part in the appendix to this reply brief, unequivocally states that the "deductibility of * * * items with respect to facilities" are to be "governed by the rule of the House bill," which disallowed entertainment expense deductions for goodwill purposes.

5. Taxpayer's assertion (Br. 44) that the code of ethics of his profession prohibits advertising is simply irrelevant to the permissibility of the claimed deductions. If taxpayer seeks the benefits of a deduction under the Code, he must comply with the provisions of the statute (and in this case, he must not

violate the disallowance rules of Section 274). Henry v. Commissioner, 36 T.C. 879 (1961) (disallowing a business expense deduction to an attorney-accountant specializing in tax work who used his boat for soft-sell advertising; he flew a burgee with the legend "1040").

6. Taxpayer's reliance (Br. 44) on LaForge v. Commissioner, 434 F. 2d 370 (C.A. 2, 1970) is entirely misplaced. Insofar as pertinent here, the question before the Court was the proper computation of the deductions (for club dues).[6/] As the Court's opinion makes clear (p. 373), the issue of whether the expenses were "directly related to the active conduct" of business, under Section 274(a)(1)(B), was not before the Court.

7. With respect to the substantiation requirements of Section 274(d) and the Regulations thereunder, taxpayer essentially admits (Br. 47-48) that he failed to prove that any specific portion of his total boat expenses were directly related to the conduct of business; indeed, he appears to defend the Tax Court's reliance on a Cohan-type[7/] approximation

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6/ There was, in addition, a question in LaForge as to whether the taxpayer, a physician, was entitled to deduct the cost of meals he purchased for his assistants in the hospital cafeteria, where no receipts were available. See our opening brief, pp. 34-35.

7/ Cohan v. Commissioner, 39 F. 2d 540 (C.A. 2, 1930).

based on the settlement of the pre-Section 274 years (Br. 50-51), a procedure explicitly prohibited under Section 274. As we have noted (Br. 32-35), the statute and the Regulations specifically require taxpayer to substantiate the precise amount of his total expenses that are properly deductible. Section 274(a)(1) (disallowing the deduction of "any item" not meeting the terms of Section 274); Section 274(d) (requiring substantiation of the amount of each "such expense or other item" and business purpose therefor); Section 1.274-5(b) (stating taxpayer must substantiate the elements of "each * * * expenditure").

8. Taxpayer's reference (Br. 48-49) to LaForge v. Commissioner, supra, p. 373, is misleading. The part of the LaForge opinion dealing with club dues clearly states that the deduction was to be permitted only for that percentage of the dues "which corresponds to the taxpayer's actual use of the facility for business entertaining." Clearly, the record in this case contains no evidence showing the precise percentage of taxpayer's use of the yacht which was directly related to the active conduct of his business.[8/]

8/ Taxpayer implies (Br. 48) that the substantiation requirements of Section 274(d) and the Regulations are to be disregarded where depreciation or other lump-sum attributes are involved. But as LaForge recognized, in such a case it is necessary to determine on an occasion-by-occasion basis the portion of total days of use which were directly related to the active conduct of a taxpayer's business, and to allocate the lump-sum amount accordingly. In this case, taxpayer failed to establish that any part of his use of the yacht was directly related to the active conduct of his business. As such, Section 274(a)(1)(B) disallows any deductions related to the yacht.

CONCLUSION

For the foregoing reasons, and for the reasons stated in our opening brief, the decision of the Tax Court should be reversed.

Respectfully submitted,

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SEPTEMBER, 1974.

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing brief has been made on opposing counsel on this 9th day of September, 1974, by mailing four copies thereof in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

H. Conf. Rep. No. 2508, 87th Cong., 2d Sess., p. 16 (1962-3 Cum. Bull. 1129, 1144):

* * *

It is the understanding of the conferees, both on the part of the House and the Senate, that the alternative Senate "or associated with" test as described in the report of the Finance Committee would apply to certain entertaining primarily to encourage goodwill where the evidence of business connection is clear, whether or not business is actually transacted or discussed during the entertainment. The conference agreement would permit a deduction for the cost of an entertainment item, even though the item is not directly related to the active conduct of the taxpayer's trade or business, if the item is associated with it, so long as the entertainment activity directly precedes or follows a substantial and bona fide business discussion. * * * The deductibility of other items of entertainment expense, as well as items with respect to facilities, would be governed by the rule of the House bill. (Emphasis added.)

* * *